

October 31, 1991

**COORDINATED ISSUE  
MERGERS AND ACQUISITIONS INDUSTRY  
EQUITY POOL INVESTMENT FEES**

**Issues:**

Whether fees paid by an investor to participate in an investment pool, created for the purpose of funding investments in future limited partnerships formed to consummate leveraged buyouts (LBO's) are:

- (1) Currently deductible under section 162 or section 212;
- (2) Partnership organizational expenditures nondeductible under section 709(a) but amortizable under section 709(b)(1);
- (3) Partnership syndication expenditures nondeductible under section 709(a) and not amortizable;
- (4) Capital expenditures, under section 263, of acquiring a capital assets, a limited partnership interest.

**Facts:**

Part of the problem in determining the tax consequences of these equity pool fees is ascertaining for what the fees are paid. Until this has been done, any final conclusions concerning the tax consequences to the investors paying these fees will be somewhat uncertain. The general outline of these transactions is set out below.

X, an investor, entered into an agreement with Y, an investment banker, to commit to make capital contributions (cash) to an Investment Partnership Fund (Fund). The Fund was to invest in one or more limited partnerships used as a vehicle or vehicles to invest in one or more LBO's organized by Y. X's obligation to the Fund was payable only upon the occurrence of a consummated LBO. The contributions to the Fund were used to acquire interests in a limited partnership which in turn invested in the LBO. Y was the general partner while X and other investors were limited partners in the limited partnership(s).

Fund participants were excused from their obligation if the selected investment "might" violate law or regulations and may subject the Fund participant to penalties. The objective of the Fund was to realize profits through capital appreciation, rather than through yield-oriented investments.

Y bears all the costs of obtaining commitments to the Fund and of locating investments. The term of the Fund Agreement is a maximum of 10 years from the date of funding. Y receives an annual fee of 2% of the amount committed by each Fund participant. This fee increases by 5% per year compounded. The fee ends after the 10 year period or when all funds committed to the Fund are invested.

Y performs at least the following services for this fee:

- (1) organization of partnerships to make investments;
- (2) organization of the investment pool and pool investors; and
- (3) location of investments, negotiation of purchase price and acquisition structure with the sellers and placement of funds in limited partnerships in order to consummate LBO acquisitions.

X has claimed a current deduction each year for the equity pool fees paid.

### **LAW AND ANALYSIS:**

The pool investors bear the burden of identifying what services Y rendered and the value of each type of service to support their claimed deductions. In the absence of such a showing all deductions would be disallowed. The Tax Court has approved such an approach in Tolwinsky v. Commissioner, 86 T.C. 1009 (1986); and Ball v. Commissioner, T.C. Memo. 1989-73 by denying fee deductions to taxpayers who failed to substantiate the extent and value of the claimed organizational expenses.

Depending upon the facts of a given case, portions of the equity pool fee could be attributable to one or more of the expenses listed below.

- (1) Partnership organizational expenses which are nondeductible (see section 709(a) but at the election of the partnership could be amortized over not less than 60 months. See section 709(b)(1). Such expenses are defined by section 709(b)(2) as expenditures: (a) incident to the creation of the partnership; (b) chargeable to capital account; and (c) of a character which, if expended in creation of a partnership with an ascertainable life, would be amortizable over that life.
- (2) Syndication expenditures (costs incurred to promote the sale of (or to sell) an interest in a partnership). Such an expenditure is not deductible pursuant to section 709(a) and is not amortizable under section 709(b)(1).

- (3) Costs of acquiring a capital asset (e.g., acquiring a limited partnership interest in a limited partnership investing in a LBO). Included in this category could be the value of services of Y in seeking a LBO investment and negotiating the purchase. Such costs are capitalized under section 263 and hence are nondeductible.
- (4) Expenditures deductible under section 162 (ordinary and necessary business expenses) or section 212 (expenses of management, conservation or maintenance of property held for the production of income). It remains to be seen whether these investors can demonstrate that some portion of these fees are deductible under section 162 or 212.

### **CONCLUSIONS:**

To the extent a pool investor demonstrates that part of the fee was attributable to the following categories of expenses, the appropriate tax consequences would apply:

- (1) Organizational expenses (section 709) - nondeductible but amortizable;
- (2) Syndication expenses (section 709) - nondeductible;
- (3) Capital expenses (section 263) - nondeductible;
- (4) Ordinary and necessary business expenses deductible under section 162;  
or
- (5) Section 212 expenses (incurred for the management, conservation or maintenance of property held for the production of income) - deductible.

In the absence of such substantiation, deductions for these fees would be disallowed.